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Mr. William F. Caton
Acting Secretary
Federal Communications Commission
1919 M Street, NW, Room 222
Washington, DC 20554

Dear Mr. Caton:

Re: *CC Docket No. 96-112, Allocation of Costs Associated with Local Exchange Carrier Provision of Video Programming Services*

On behalf of Pacific Bell and Nevada Bell, please find enclosed an original and six copies of their *"Comments"* in the above proceeding.

Please stamp and return the provided copy to confirm your receipt. Please contact me should you have any questions or require additional information concerning this matter.

Sincerely,

Jay Bennett

Enclosure

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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C 20554

MAY 31 1996

In the Matter of Allocation of Costs Associated with Local Exchange Carrier Provision of Video Programming Services	CC Docket No. 96-112

COMMENTS OF PACIFIC BELL AND NEVADA BELL

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Date: May 31, 1996

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SUMMARY

In this NPRM the Commission asserts its intent to further the pro-competitive, deregulatory policies of the 1996 Telecommunications Act relative to cost allocation rules for video services. The Commission can best accomplish those policies by forbearing from unnecessary regulation or eliminating irrelevant regulation altogether The first application of that policy should be for the Commission to forbear from applying Part 64 rules to price cap LECs that choose a no sharing option. Under a no sharing option, ratepayers will pay telephone rates that are just and reasonable. Because the no sharing option severs the final tenuous link between costs and regulated rates, there is no possibility that regulated services will cross-subsidize nonregulated services.

Competition entirely eliminates the need for cost allocation requirements. With effective competition, the Commission can effectuate Congress' intent by eliminating all Part 64 rules. The extent of competition for the services Pacific Bell provides suggests that cost allocation rules are unnecessary. Governmental intervention should give way to market forces where competition tempers costs, rates and prices. Only LECs are subject to Part 64 regulatory costs. That economic burden, avoided by our competitors, can have a real effect on decisions to provide nonregulated services. Eliminating unnecessary and costly regulation will encourage the rapid deployment of new services, consistent with the goal of the Telecommunications Act.

Where cost allocation rules are necessary (under traditional rate of return regulation), the Commission should maintain its well-founded approach of Part 64. The Commission's general guidelines reflecting cost allocation principles will permit LECs to allocate joint and common outside plant cost in a manner that is appropriate to their networks and services. General guidelines will meet the Commission's stated criteria for cost allocation rules that further the goals of the 1996 Act We

urge the Commission to endorse general guidelines that permit each LEC to use a method that will best meet its particular network architecture and services.

Consistent with a flexible approach to cost accounting, Pacific Bell allocates the common costs of its hybrid fiber coax plant based on directly assigned plant. We believe this method most closely approximates the long run incremental costs of the network and satisfies the Commission's criteria better than the several other allocation methods that the Commission reviews: Allocation based on usage would send an unreasonable amount of costs to nonregulated services and potentially discourage LEC entry into video services. Both capping regulated loop costs and fixed factor allocation ignore the Commission's first criteria--cost causation. Because no "one size fits all" approach can properly allocate the array of network architectures and future innovations, allocation based on cost ceilings or a single, industry-wide fixed factor would be arbitrary and capricious and may be confiscatory. A 50/50 fixed factor requirement for all LECs is especially arbitrary and suggests erroneous assumptions about the proportions of regulated and nonregulated costs and cost recovery.

Whatever allocation a carrier uses, the Commission should not permit exogenous treatment for reclassified investment. Exogenous treatment is not justified when new services share embedded facilities because reclassification does not result in a cash flow effect, a necessary element according to the Interim LEC Price Cap Order. Moreover, for price cap LECs, the Total Factor Productivity methodology tentatively adopted by the Commission reflects economies of scope through reductions in the price cap indices. Permitting exogenous treatment in addition would improperly pass on those economies twice--a double reduction. If, however, the Commission permits exogenous treatment, only regulated investment included in the cost forecasts for the period of July 1990 to

June 1991 should be subject to exogenous treatment. Removing investment not included in price cap regulation would be an inappropriate transfer of shareholder value to ratepayers.

Part 64 cost principles permit LEC's flexibility to determine allocation of their expenses using methods appropriate to their circumstances. The Commission should maintain these Part 64 rules. Similarly, the Commission should maintain the current cost causative treatment of spare facilities under Part 64 wherein allocation of spare capacity follows the allocation of the deployed outside plant. Finally, pole attachment rates which we charge to third parties qualify as a prevailing price under Part 64 rules. A carrier can impute this amount for its own use of poles and conduit pursuant to section 224 (g) of the 1996 Act.

The Commission's choices in this rulemaking will encourage or discourage the rapid development of video services. Congress' intent in this regard is clear from the 1996 Act. The Commission must act to endorse competition and reduce unnecessary regulation. We believe our recommendations promote those goals.

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of Allocation of Costs Associated with Local Exchange Carrier Provision of Video Programming Services	CC Docket No. 96-112

COMMENTS OF PACIFIC BELL AND NEVADA BELL

I. Introduction

Pacific Bell and Nevada Bell respectfully comment on the Commission's far-reaching cost allocation proposals in the above-captioned proceeding.[1] The NPRM raises issues that go far beyond the treatment of video services. Although the Commission notes that the rules developed here may apply to a "panoply of broadband-based, nonregulated services [that] share facilities with regulated services," the Commission has not given parties adequate time to address the effect of its proposals on the broad range of potential nonregulated services.[2] The Telecommunications Act of 1996 does not require the Commission to complete this rulemaking within a prescribed period.[3] Thus,

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[1] *Allocation of Costs Associated with Local Exchange Carrier Provision of Video Programming Services*, CC Docket No. 96-112, Notice of Proposed Rulemaking ("NPRM"), released May 10, 1996.

[2] NPRM, para. 2. The Commission initially allowed 18 days for the development of comments. The Commission has since extended the comment date by 3 days to May 31.

[3] Telecommunications Act of 1996, Pub.L. No. 104-104, 101 Stat. 56 (1996) ("1996 Act").

we ask the Commission to defer ruling on the cost allocation treatment of nonregulated services other than video services until it initiates another comment round or rulemaking for other nonregulated, non-video services. However, in the event the Commission does not allow parties additional comment, we briefly address cost allocation rules in general

We applaud the Commission's recognition of the effective power of the marketplace to set prices and foster the development of new services. We are encouraged that the Commission opens this proceeding by restating Congress' goal in enacting the 1996 Act: to "provide for a pro-competitive, de-regulatory national policy framework designed to accelerate rapidly private sector deployment of advanced telecommunications and information technologies and services to all Americans by opening all telecommunications markets to competition . . . ."[4] The Commission identifies three goals for this proceeding: first, to give effect to the intent of Congress in enacting the 1996 Act to facilitate the development of competitive telecommunications service offerings; second, to encourage and foster LEC entry into video distribution and programming services markets; third, to ensure that ratepayers pay telephone rates that are just and reasonable, and see to it that incumbent LECs do not use services that are not competitive to subsidize services that are subject to competition.[5] We submit our comments with these goals in mind.

[4] H.R. Conference Report 458 Cong., 104th Congress, 2d Session, February 1, 1996, p. 113. (Conference Report).

[5] NPRM, para. 22.

II. The Commission Should Forebear From Applying Part 64 To Price Cap Carriers That Elect The No Sharing Option

The Commission initiates this proceeding to amend its cost allocation rules and procedures in order to regulate incumbent local exchange carriers (LECs) that choose to provide (nonregulated) video programming directly to subscribers in its telephone service area. The Commission's Part 64 cost allocation methods ensure that the costs of regulated services are properly identified and segregated from nonregulated service costs so that regulated rates are based only on regulated costs. However, for most large LECs, identifying and segregating regulated and nonregulated costs are irrelevant and unnecessary. Part 64 is absolutely unnecessary when a price cap company elects a no sharing price cap option.

Under price cap regulation, LECs' rates are not tied directly to cost allocations.[6] Rather, prices of services (within specific baskets) are capped and subsequently influenced only by changes in general inflation, productivity and exogenous costs. Thus, the link between cost allocations and regulated prices is limited to that vestige of rate of return regulation known as the "sharing mechanism". Without the sharing mechanism, there is no link at all between cost allocations and regulated rates and no possibility that regulated services will subsidize nonregulated services. Cost allocation requirements are irrelevant for price cap LECs that have elected the no sharing option.

Currently, each LEC can annually elect a sharing or no sharing price cap regulation plan.[7] For the past two annual filings, Pacific Bell (and most other price cap LECs) chose the no

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6 *Computer III Remand Proceedings*, 6 FCC Rcd 7571 (1991), para. 55.

7 *Price Cap Performance Review for Local Exchange Carriers*, 10 FCC Rcd 8961 (1995), para. 184 ("Interim LEC Price Cap Order").

sharing option.[8] For these LECs, calculations of regulated and nonregulated costs are irrelevant to their regulated rates. Simply said, their costs don't affect their rates under a no sharing price cap plan. Concerns about cross-subsidy are clearly misplaced when costs cannot affect regulated rates. The Commission no doubt recognizes that our competitors' proposals to retain burdensome and costly regulatory processes under the guise of "cross subsidies" are merely attempts to obtain an unfair competitive advantage. The 1996 Act intends that all parties, including LECs, be provided fair opportunities to compete. The Commission must adopt rules that foster the purpose of the 1996 Act.

The Commission need not apply Part 64 rules in order to protect nonregulated service prices. The marketplace effectively regulates the prices of competitive services. Moreover, Part 64 rules do not and were not intended to affect nonregulated services prices. The Commission recognized that nonregulated service prices should be left to the business judgment of the company and the market place.[9] Nonregulated service prices must meet antitrust guidelines which consider economic, not regulatory, costs.

Similarly, the Commission need not apply Part 64 rules in order to protect intrastate ratemaking. The Commission has clearly acknowledged the states' jurisdiction over intrastate ratemaking.[10] Moreover, because of the varied regulatory plans in state jurisdictions -- in some states all services are totally deregulated; in others, services are subject to price cap plans and in yet others, services are still measured under rate of return -- a local commission can better determine the factors

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[8] Those LECs assume more risk (through the significantly higher 5.3% X-Factor) in exchange for the potential to realize greater earnings.

[9] *Separation of Costs of Regulated Telephone Service from Costs of Non-regulated Activities*, 2 FCC Rcd 1298 (1987)("Joint Cost Order"), para. 115; 2 FCC Rcd 6283 (1987) ("Joint Cost Recon. Order"); 3 FCC Rcd 6701 (1988) ("Joint Cost Further Recon. Order").

[10] Joint Cost Recon. Order, para. 164, n.254.

necessary to ensure reasonable intrastate rates. Some state commissions have in fact adopted Part 64 rules as the basis for their own cost allocations.[11] The Commission should focus its attention on ensuring just and reasonable rates for customers of regulated interstate services.

Part 64 should be entirely eliminated when there is effective competition for LEC services. Government intervention should give way to market forces where effective competition tempers costs, rates, and prices. Pacific Bell no longer has a monopoly on any service. In California, competition exists for intraLATA long distance service and for local service. The California Public Utilities Commission (California) has certified more than 30 facilities-based providers and more than 60 resale providers to provide local service.[12] The Commission's own inquiry determined that the long distance services market is competitive. And, with our entry, the video services market that we enter will be clearly competitive. With full blown competition, regulations established to protect ratepayers, such as Part 64 cost allocation rules, are unnecessary.

On the other hand, the Part 64 requirements impose substantial administrative and financial burden on both LECs and the Commission (for example, filing and maintaining cost allocation manuals, implementing complex cost accounting systems and studies to carry out the procedures described in the CAM, training personnel on time and cost reporting procedures, preparing reports related to Part 64 accounting, and paying substantial sums for audit fees). These numerous and costly requirements can inhibit LEC entry into competitive services because competitors do not have

[11] California has largely adopted the Commission's Part 64 rules but has established exceptions for affiliate transactions and differs in its regulatory treatment of some services.

[12] Competition for Local Exchange Service, CPUC Decision No. 95-12-056, slip op. (December 20, 1995); CPUC Decision No. 96-02-072, slip op. (February 23, 1996).

these substantial burdens. Moreover, the administrative cost of complying with regulation, which ultimately raises the price of nonregulated services, has no direct benefit to consumers.

With the link between costs and regulated rates severed by price cap regulation, and with growing competition for LECs' services, the Commission should give effect to the deregulatory intent of the 1996 Act by eliminating unnecessary cost allocation regulation and by otherwise reducing, not increasing, its oversight of regulated services Forbearing from applying Part 64 rules to price cap LECs accomplishes this goal.

III. To The Extent Continued Cost Allocation Rules Are Necessary, General Guidelines Will Permit Greater Flexibility And Cost Causative Allocation

Where the form of regulation or extent of competition requires continued allocation of costs between regulated and nonregulated activities, we urge the Commission to maintain the well-founded approach it adopted in Part 64 and continue to apply these principles to the allocation of loop plant and other network facilities.[13] General cost allocation guidelines are consistent with economic principles of cost causation and adaptable to any network architecture and service. General rules can also provide uniformity and meet the Commission's goal of administrative simplicity.[14] However, neither of these goals should take precedence over sound cost accounting principles.

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[13] Contrary to the NPRM, at paragraphs 2 and 19, the Commission spent considerable effort in the Joint Cost Order on the allocation of central office equipment and outside plant. Joint Cost Order, paras. 167-172; Joint Cost Recon. Order, paras. 15-70; Joint Cost Further Recon. Order, paras 16-41.

[14] In Part 64, the Commission imposed uniformity only in "selected areas in which the LECs' operations are very similar and their current CAM differences are more attributable to individual preferences than differing operational characteristics. Therefore, we will adopt *minimum* CAM uniformity requirements ..." (emphasis added). *Implementation of Further Cost Allocation Uniformity*, 8 FCC Rcd 4664 (1993), para. 6.

The Commission should not impose specific cost pools and allocation methods. First, prescribed cost pools presume uniform deployment of network architectures and services by all LECs. This is clearly not the case today and is even less likely in the future as new technologies and services develop. LECs implement different network architectures in response to existing infrastructure and market demands (for example, ADSL over an existing copper network; hybrid fiber coax design; fiber to the curb). The amount and nature of the costs associated with each kind of network vary significantly. Applying a uniform allocation method to differing circumstances compromises the fundamental cost accounting tenet that costs should be attributed on the basis of causation.

Second, a network's architectural design determines the costs of central office and outside plant. Thus, the best way to capture those costs is to use a method that allocates costs on the basis of cost causation which is what Part 64 rules do. Part 64 directly assigns costs where possible and allocates joint and common costs based on direct or indirect measures of cost causation.

a. Direct Assignment Of Network Plant Costs

Direct assignment of costs is a fundamental cost accounting principle which is applicable to all network plant including loop plant. Specific network components can be identified as used for one service or another. For example, currently, Pacific Bell's outside plant provides only regulated telephone service.[15] In addition, certain components of the network, such as circuit equipment, provide only telephone service or only video services.

[15] Pacific Bell is constructing a hybrid fiber-coax (HFC) broadband network capable of providing both regulated and nonregulated services. A video technology trial is underway to approximately 1000 homes in California as of May 1996.

b. Allocation Of Network Plant Common Costs

By definition, common costs vary based on the use of common plant.[16] The services that incur common costs should therefore share proportionately in the common costs based on relevant cost drivers. Part 64 permits LECs to apply cost accounting principles to derive cost allocators that meet the unique circumstances of their service offerings.

c. Allocation Of Joint Network Plant Costs

Joint network costs are incurred whether the carrier provides one or more services.[17] For example, the cost of installing aerial coax cable would be incurred whether only telephone service or only video services were provided. A number of different approaches will yield reasonable joint cost allocations. Each may have merit, and one may fit the unique needs of a carrier better than others. Each LEC is in the best position to determine the allocation of joint costs to properly reflect its network technology, services, market conditions, and other factors, such as geographical constraints. LECs need to be able to use methods appropriate to their particular circumstances.

[16] A common cost is one in which a cost causative relationship can be determined by varying the service outputs and observing the effect on total cost. NPRM, para. 9, n.19.

[17] NPRM, para. 9, n.19.

d. The Allocation Of Joint Network Plant Based On The Amount Of Directly Assigned Network

Consistent with a flexible approach to cost accounting, we believe that the best allocator for our joint costs is based on cost elements found in the network. Pacific Bell allocates the joint HFC network plant based on directly assigned network plant.[18]

Costs of our HFC network plant can be identified as joint or directly assigned. While directly assigned amounts vary as additional services are provided over the network, the joint costs do not. The direct costs associated with all services represent the HFC network incremental costs. Over time, these directly assigned amounts represent the long run incremental costs of the network. Joint costs should be allocated in a manner that most closely approximates the long run incremental costs of each service or group of services. The use of directly assignable costs best achieves this objective.

The allocation of joint network plant based on the amount of directly assigned network plant satisfies each of the Commission's stated cost allocation criteria.[19] Allocations based on directly assigned investments follow cost causation principles: can be applied to any network and any service delivered over the network: are easy to administer -- both the directly assigned and joint costs are readily and discretely identifiable in financial records: and can be uniformly applied.

The concerns raised by the NPRM about allocation based on directly assigned plant are misplaced.[20] First, it would be extremely difficult for a LEC to disguise investment that is used to

[18] Pacific Bell includes as directly assigned costs, the assets associated with the functionality of the new hybrid network. Embedded telephone assets previously assigned to regulated operations, such as electronic switching systems, are not included as a directly assignable cost of the new network.

[19] NPRM, para. 24.

[20] NPRM, para. 34.

provide only telephone service from that which provides only video or other competitive services. The amount of investment which is used to develop cost allocation ratios are actual financial expenditures required to build the network according to engineering plans. A review of financial and engineering records would easily reveal improperly classified investments.

Second, the allocation of joint costs based on the proportional relationship of the associated directly assigned plant follows sound cost accounting principles. Both Part 64 cost allocation rules and Part 36 jurisdictional Separations rules apply proportional allocation. In addition, the use of relatively small amounts to develop ratios which are used to allocate large costs has precedence in Part 64.[21] A small amount of direct cost may accurately be used to allocate a large amount of joint cost because the nature of wireline networks is such that joint costs tend to be much larger than direct costs.[22] Moreover, the fact that a small increase or decrease in a direct cost can result in a large change to the allocation of joint costs should not be of concern because directly assigned costs are the most cost-causative allocator of joint costs since the electronics (the direct costs), not the pipeline (joint cost), determine the various services provided by the network.

IV. Other Approaches For The Allocation Of Joint Costs Lack The Advantages Of Allocation Based On Directly Assigned Costs

The Commission reviews a number of other cost allocation methods. Each method has significant disadvantages relative to the Commission's criteria and may impede the Commission's ability to meet its goals for this proceeding.

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[21] For example, amounts associated with marketing productive time are used to allocate associated salary related costs including nonproductive time, benefits and miscellaneous expenses.

[22] For example, significantly more labor is needed to trench and hang cable than to install directly assignable electronics in a central office.

a. Allocation Based On Usage Would Inhibit The Development Of Video Services

The Commission tentatively concludes that allocation factors based on network usage characteristics would produce results that would thwart achievement of the Commission's goals and objectives by establishing disincentives for LEC innovation.[23]

The Communications Act charges the Commission with encouraging technological innovation.[24] The 1996 Act intends to promote competition in video services by encouraging LEC entry and by permitting LECs to tailor services to meet the unique competitive and consumer needs of individual markets.[25] The Commission is correct about differences in the usage characteristics of telephone and video services that make usage an inappropriate allocator. Allocation of joint costs based on usage would allocate an unreasonable amount to video services and potentially discourage LECs from entering the video market.

b. Cost Allocation Ceilings Are Arbitrary And Not Cost Causative

The Commission proposes an alternative that would cap the total loop costs that can be allocated to regulated operations. The capped cost would be adjusted annually by the net of inflation and productivity, much like the price cap basket costs are adjusted today.[26] We strongly oppose this arbitrary and economically unsound methodology

[23] NPRM, para. 33.

[24] 47 U.S.C. §151.

[25] Conference Report, p. 227

[26] NPRM, paras. 35, 36, n.49.

Capping loop costs ignores the Commission's first criteria for the cost allocation rules -- cost causation. There is unlikely to be any relationship between the cost ceiling and ongoing actual costs of building and maintaining loops. Moreover, the loop cap method assumes incorrectly that loop costs continually decrease over time. Our experience is that network costs have increased and decreased due to changes in accounting methods, investment levels, investment deployment, and the mix of technology.

In order to implement the loop cap method on an exchange by exchange basis as proposed, the Commission would have to obtain significant amounts of data from LECs. Any approach that increases the extent of Commission oversight and carriers' regulatory burden is inconsistent with the intent of the 1996 Act. The Act directs the Commission to decrease regulation and reduce administrative burdens to promote competition. Because it would be administratively inefficient and generate an arbitrary result, the Commission should not adopt a cap on regulated loop costs.

If, notwithstanding these disadvantages, the Commission nonetheless adopts a cap on loop costs, it should not define the ceiling by adjusting the past year total cost per loop by adding the inflation factor and subtracting the company's productivity factor as suggested at para. 36 of the NPRM. Loop costs already incorporate inflation levels and productivity improvements. Applying additional inflation and productivity factors recognizes these effects twice. Loop costs, like other costs in our business, are subject to incentive regulation. The Commission adopted incentive regulation to reward LECs that can outperform the annual adjustment mechanism by permitting them to retain reasonably higher earnings than under rate of return regulation. To now apply an artificial constraint to these costs is contrary to incentive regulation. Moreover, adjusting the cost ceiling would be essentially a meaningless exercise since under price cap regulation, rates are not set based on cost levels.[27]

c. Fixed Factor Allocations Do Not Comply With Cost-Causation Principles

The Commission tentatively concludes that a fixed factor for allocating loop plant common costs should be prescribed because cost causative allocation is not possible.[28]

A fixed factor approach is not the best means to allocate joint and common costs of regulated and nonregulated services. Despite the appealing simplicity of the fixed factor method, there are several disadvantages associated with the use of a single industry-wide fixed factor. First, we believe that a cost causative allocator, such as directly assigned plant, can be used to allocate loop plant. As the Commission recognizes, a uniformly applied fixed factor will not be cost causative. A fixed factor will have little nexus to the costs of the network, and particularly to the specific relationship between the loop plant and the rest of the network. This is particularly true when the nature of the networks and the services provided differ greatly from LEC to LEC.

A fixed factor, unless revised periodically, will not reflect the technological evolution of the network. It fails to mimic market forces that change constantly. However, the biggest disadvantage in establishing a fixed factor is that LECs may make critical decisions about deployment

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[27] The Commission should reject any thought of setting Carrier Common Line Charges (CCLCs) based on these capped loop costs. To do so would be clearly improper since CCLCs reflect GDP-PI, X-factor (including productivity) and a "g" factor that returns half of the growth in volumes to ratepayers. Applying yet another artificial price constraint would be clearly inappropriate. Moreover, as we discuss in Section V.a. below, the TFP method that the Commission has tentatively adopted will reflect (and thus eliminate the Commission's concern about) sharing the economies of scope. NPRM, para. 36.

[28] NPRM, para. 40.

of technology and new services that are contrary to those that would be made based on market forces.[29] In effect, regulation-- not sound business judgment-- would dictate competitive decisions.

The Commission may view the use of a fixed 50 percent allocation factor as an attractive solution. But this allocator incorrectly assumes that the regulated and nonregulated costs of the network are equally incurred and therefore should be equally recovered by users of both services. It also incorrectly assumes that the LECs can expect to recover such costs equally.

A fixed 50 percent allocator would over-allocate costs to nonregulated video services. Pacific Bell and Nevada Bell, like other LECs, are providers of telephone services.[30] As the required provider of last resort, we are obligated to provide telephone service to all consumers in our service areas. On the other hand, LECs will be competing in the video services market against entrenched cable TV companies that serve a majority of households in the country.[31] It is unrealistic to assume that, even in the long run, a multi-service network would provide cable service to every telephone service subscriber. Yet that is exactly what a 50 percent allocator does.

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29 The seventy two percent allocation that CCTA suggested in its Petition To Deny Pacific Bell's Section 214 VDT application was such a disproportionate assignment of cost to the nonregulated service that it is likely that video dialtone service would never have been introduced to the marketplace if that ratio had been adopted -- an outcome which may have motivated CCTA's suggestion.

30 Pacific Bell would build the HFC network even if we chose not to provide any enhanced or video services. Operational savings, over time, would more that cover the cost of constructing the new network that will offer better quality telephony services.

31 If the allocation ratio is too high to economically justify entering new markets with video and other nonregulated service, Section 302 of the 1996 Act encouraging telephone companies to provide cable service, would be nothing more than useless prose.

Fixed factors like 50 percent are avoided by Part 64 for good reason -- the notion of cost causation is its core principle. In the final analysis, nothing could be more arbitrary than a 50/50 allocation.[32]

A fixed factor for loop plant may be reasonable for Part 36 jurisdictional Separations rules for a number of reasons that do not apply here. First, Separations fixed factors have been used only where the nature of the costs is such that there is no other meaningful basis for apportionment. This is not the case for allocating network plant between regulated and nonregulated services. Allocating plant between regulated and nonregulated services based on directly assigned plant is reasonable and easily accomplished.

Second, the Separations process has a long history with a lengthy record of allocated costs. Thus, historical records have justified the use and selection of specific fixed factors. Clearly, no such record exists for the allocation of joint and common network plant costs.

Finally, Separations allocates costs between regulatory jurisdictions, identifying the jurisdiction from which costs should be recovered. Unlike the allocation proposed for regulated and nonregulated service costs, ratepayers bear all of the costs allocated by Separations fixed factors. Fixed Separations factors do not have the potential of inhibiting the development and introduction of new services. On the other hand, improper allocation of costs to a nonregulated service carries significant risk of nonrecovery. Use of a fixed factor, with the possibility of over-allocating costs to

[32] SNET offered a 50/50 allocation in its application to construct facilities for VDT service. However, that offer was for a regulated service and should not be applied to allocate costs of competitive services. In its filing, SNET pointed out that as new telephony applications are developed, cost allocations among all services using common facilities would be reexamined. The 50/50 approach appears to have been intended as an interim factor until more accurate information could be obtained. *Application Under Sec. 214 for Permission to Construct Facilities*, Southern New England Telephone, filed January 25, 1996.

new nonregulated services, could negatively influence management decisions about introducing new products and services.

V. Specific Cost Allocation Issues

a. The Commission Should Not Prescribe Exogenous Treatment For Reclassified Embedded Investment When Facilities Are Shared With New Nonregulated Services

The Commission seeks comment on whether cost reallocations from regulated to nonregulated activities should be treated exogenously and trigger reductions in price cap indices.[33]

Exogenous treatment is not appropriate for changes in usage. As the Commission recognizes "...most changes in a carrier's costs of providing regulated services are treated as 'endogenous' and do not result in adjustments to the carrier's price cap indices."[34] Infrastructure improvements were never permitted to be included in price cap rates. Changes in usage should not be defined as a "reallocation". That term describes underforecasts of nonregulated costs.[35] In order to encourage carriers to make accurate usage forecasts of nonregulated services, the Commission established exogenous treatment as a means to redress the misallocation. A change in the status of embedded facilities when they are later shared by nonregulated services should not be deemed to be a "reallocation" that triggers exogenous treatment

Moreover, expanding the exogenous cost rules to apply to the reclassification of embedded investment is inconsistent with the Commission's previous determination that progress

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[33] NPRM, para. 60.

[34] NPRM, para. 58.

[35] Joint Cost Recon. Order, para. 33, n.32.

toward market based rates will be impeded if exogenous cost adjustments continue to be allowed.[36] That policy reason was the basis for the Commission's decision in the Interim LEC Price Cap Order for also requiring a cash flow effect for accounting changes to qualify for exogenous treatment.[37] Changes to the regulated status of embedded facilities will not have a cash flow effect and thus should not be treated exogenously.[38]

The Commission appears to suggest the exogenous treatment of embedded facilities as a way for ratepayers to share in the economies of scope Exogenous treatment is not necessary because the Total Factor Productivity (TFP) methodology (with annual updates through a moving average) that the Commission has tentatively adopted in the Interim LEC Price Cap Order[39] will automatically pass on all economies of scope to telephone ratepayers.[40] Ratepayers have the benefit of the economies of scope because under Part 32 rules, nonregulated services that have joint and common inputs with regulated services are included in operating revenue and operating expenses. The TFP includes these revenues and expenses. Therefore, all joint and common cost savings realized by a network are in the

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[36] The Commission said "Progress toward market-based rates and away from rate of return regulation will be impeded, however, if we continue indefinitely to allow exogenous cost adjustments that have the purpose and effect of perpetuating the relationship between accounting costs and rates that existed on July 1, 1990". Interim LEC Price Cap Order, para. 299.

[37] The Commission provided further clarification by stating that if an accounting change has no impact on a LEC's cash flow, an investor will earn the same return before and after the change. A cash flow effect causes a change in the return earned by an investor Interim LEC Price Cap Order, paras. 295, 296.

[38] New nonregulated investment in the broadband network should not require any adjustments to the price cap indices. Under price cap regulation new investment is treated endogenously -- that is, it is not included in regulated rates.

[39] Interim LEC Price Cap Order, para. 11.

[40] Comments of the United States Telephone Association on Fourth Further Notice of Proposed Rulemaking, filed January 16, 1996, *Price Cap Performance Review for Local Exchange Carriers*, CC Docket No. 94-1 (Selected pages of Attachment A included as Attachment 1).

TFP value. The TFP will be included in the productivity factor that the Commission requires price cap LECs to annually apply to their price cap indices (PCIs). All economies of scope will therefore be passed through to telephone ratepayers through reductions in the PCIs. No other reductions are appropriate and, in fact, exogenous treatment of reclassified embedded facilities would be a double reduction.

If, however, the Commission chooses to treat cost of reclassified embedded investment as exogenous, such treatment should apply only to investment included in the initial price cap rates. Those rates were based on cost forecasts for the period July 1990 - June 1991. All new investment since then has never been included in price cap rates. Because such new investment has never been part of the price cap equation, it should not be "taken out of" price cap rates. To do so would result in an inappropriate transfer of shareholder value to ratepayers In order to properly treat investment as exogenous when its usage changes, we would have to first determine the vintage of the investment being reclassified to determine if the investment was included in the initial price cap rates. This task would be extremely burdensome, if possible at all.[41] In any event, the TFP value that will be used to reduce the PCIs provides benefits to the ratepayers on all vintages of investment and passes on the economies of scope associated with a network that is used for both regulated and nonregulated services.

[41] For example, Pacific Bell does not track poles by vintage.